RAILROAD COMMISSION OF TEXAS

OFFICE OF GENERAL COUNSEL

GAS UTILITIES SECTION

STATEMENT OF INTENT TO CHANGE SALES AND TRANSPORTATION RATES OF TEXAS SOUTHEASTERN GAS COMPANY ESTABLISHED IN GUD NOS. 8749-8754	**§**	**DATE ISSUED: April 28, 2000**
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	§	**GAS UTILITIES DOCKET NO. 8958**
	§	
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PROPOSAL FOR DECISION

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RAILROAD COMMISSION OF TEXAS

STATEMENT OF INTENT TO CHANGE SALES AND TRANSPORTATION RATES OF TEXAS SOUTHEASTERN GAS COMPANY ESTABLISHED IN GUD NOS. 8749-8754	**§ § § § §**	**GAS UTILITIES DOCKET NO. 8958**

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1. Introduction

This case involves the Statement of Intent to increase rates filed by Texas Southeastern Gas Company Inc. (TSE) on July 30, 1999 with the Railroad Commission of Texas (Commission). TSE seeks to increase its sales and transportation rates from those that were set by the Commission in Gas Utilities Docket (GUD) Nos. 8749-8754[1] in April 1999, for the Cities of Brenham, Hempstead, Navasota, Sealy, Tomball, and Waller, Texas (Cities). The proceeding for GUD Nos. 8749-8754 were initiated by a complaint filed by the Cities against TSE that resulted in the contracts being set aside and rates being set by the Commission. With this Statement of Intent, TSE seeks to increase only those city gate rates for the six cities listed above.

The Examiners recommend that the Commission deny TSE's requested rate increase and dismiss TSE's Statement of Intent because TSE failed to meet its burden of proof for its requested rates, and failed to present adequate evidence to set a cost of service rate. Also, the Examiners recommend that the Commission deny TSE's request to recover its rate case expenses because TSE failed to meet its burden of proof.

2. Jurisdiction

The Commission has jurisdiction over these matters under Texas Utilities Code Sections 102.001(a), 121.051, and 121.151.[2] The statutes and rules involved include, but are not limited to, the following: Texas Utilities Code Chapters 101, 102, 104 and 121; and Commission Rules, Chapters 1 and 7.[3]

3. Procedural History and Notice

On July 30, 1999, TSE filed a Statement of Intent to change the city gate sales rates and the transportation rates established for the Cities. In its Statement of Intent, TSE requested the following changes to its current rate schedule:

> A city gate sales rate equal to the Inside FERC Houston Ship Channel/Beaumont, Texas index (large packages only) (HSC Index) for the first day of the month for which gas is being billed, adjusted for variances in gas actually taken, plus 65.4 cents per MMBtu.

[1] Tex. R.R. Comm'n, *Complaint of the Cities of Brenham, et al. Against Texas Southeastern Gas Company,* Gas Utilities Docket (GUD) Nos. 8749-8754.

[2] TEX. UTIL. CODE ANN. § 102.001(a), 121.051, and 121.151 (Vernon 1998).

[3] 16 TEX. ADMIN. CODE, Ch. 1 & 7 (West 1999).

A transportation rate of 65.4 cents per MMBtu, subject to adjustment for imbalances between nominations and actual deliveries.

TSE's Statement of Intent proposed September 3, 1999 as its proposed effective date for the new rates. The Commission issued a Suspension Order on August 24, 1999, which suspended the proposed rates for a period of one hundred fifty (150) days from the date the rates would otherwise go into effect, as authorized under Texas Utilities Code Section 104.107.[4]

The first prehearing conference was held on August 30, 1999, and the Cities were granted intervener status in opposition to TSE's requested rate increase. At the prehearing conference, the Examiners approved the form of notice to be published, and TSE represented that notice would be published for four consecutive weeks, starting the week of August 30, 1999. During the conference, the parties also agreed to an extension of TSE's proposed effective date and the deadline for Commission action in this case in order to allow the parties an opportunity to participate in mediation. The Examiners scheduled the evidentiary hearing to begin on November 17, 1999.

The hearing was convened on November 17, 1999; however, due to TSE's announcement that notice had not been published beginning the week of August 30, 1999 as originally represented, the Examiners ruled that the hearing could not go forward. Examiners' Letter No. 5, issued November 19, 1999, directed TSE to publish notice and rescheduled the evidentiary hearing for December 17, 1999. Examiners' Letter No. 5 also established TSE's effective date as December 4, 1999, resulting in a rate bond-in date of March 3, 2000. Although TSE appealed to the Commission with respect to the bond-in date, the Commission denied the appeal by Order signed December 7, 1999.

TSE subsequently complied with the statutory notice requirements and published the notice as approved by the Examiners for four successive weeks between November 10, 1999 and December 9, 1999. On December 16, 1999, the State of Texas filed a Motion to Intervene and a Motion to Continue Hearing. On December 17, 1999, the Examiners postponed the hearing to January 21-26, 2000, and allowed the State intervener status on behalf of affected state agencies, hospitals, and colleges within the corporate limits of the cities served by TSE. On January 14, 2000, the Examiners denied party status to Prairie View A&M University, Brenham State School, and the Texas Department of Criminal Justice, all represented by the State of Texas.

During the pendency of this docket, the Cities filed two motions to dismiss. The Examiners denied the first motion on October 22, 1999, and denied the second motion on January 20, 2000.

[4] TEX. UTIL. CODE ANN. § 104.107 (Vernon 1998).

An evidentiary hearing was held on January 21-26, 2000. TSE pre-filed testimony and presented evidence at the hearing. Although the Cities and State did not file testimony or present any witnesses, they participated at the hearing by cross-examining the witnesses. TSE presented three witnesses: Ronald Nelson, Cost of Service Consultant to TSE; Paul G. Doll, former Executive Vice President of TSE; and Kirk Sprunger, Chief Financial Officer of the Yuma Companies, Inc. (Yuma). At the Examiners' request, Sam Banks, President and CEO of Yuma, was also presented as a witness for TSE.

The Examiners held a Post-hearing Conference on February 7, 2000, wherein they continued the hearing for the submission of additional evidence. The Cities and the State appealed the Examiners' ruling, and on February 24, 2000, the Commission granted the appeals, reversing the Examiners' ruling, and directing the Examiners to proceed to a decision on the record developed at hearing.

On February 15, 2000, TSE filed additional information as requested by the Examiners. The information was not admitted as evidence, per the Commission's February 24, 2000 ruling.

On February 24, 2000, TSE re-designated January 17, 2000 as the proposed effective date, making June 15, 2000 the decisional deadline under Texas Utilities Code Section 104.107, and April 16, 2000 the date when rates could be bonded in per Texas Utilities Code Section 104.109.[5]

Closing arguments and replies were filed by TSE, the Cities and the State on March 14, 2000 and March 21, 2000 respectively. On March 24, 2000 the Examiners held a hearing on rate case expenses. Briefs on rate case expenses were filed on April 4, 2000, and Reply Briefs were filed on April 7, 2000. The Examiners closed the record on April 7, 2000.

4. Overview and Examiners' Recommendation

TSE is a gas utility and is subject to the cost of service standards in Titles 3 and 4 of the Texas Utilities Code. TSE filed a Statement of Intent under Texas Utilities Code Section 104.102.[6] The Examiners recommend that the Commission deny TSE's requested rate increase and dismiss TSE's Statement of Intent. The Commission must determine if TSE met its burden of proving that its proposed rates are just and reasonable under Texas Utilities Code Section 104.008.[7] After a thorough review of the hearing transcripts, closing statements, and replies by the parties, the Examiners believe that TSE did not meet its burden for four key reasons. First, TSE cannot claim the presumption of justness and reasonableness of TSE's investment and expense items in Commission Rule 7.58[8] because it did not use proper accounting methodologies as required by Commission rules. Second, TSE did not introduce reliable evidence that supports its claimed investment, revenue and expense items. Third, TSE failed to meet the affiliate transaction standard[9] for all of its affiliate transactions, which make up a large majority of its expenses. Fourth, TSE did not fully address or support typical gas utility revenue and expense adjustments and rate design methods.

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[5] TEX. UTIL. CODE ANN. § 104.109 (Vernon 1998).
[6] TEX. UTIL. CODE ANN. § 104.102 (Vernon 1998).
[7] TEX. UTIL. CODE ANN. § 104.008 (Vernon 1998).
[8] 16 TEX. ADMIN. CODE § 7.58 (West 1999).
[9] TEX. UTIL. CODE ANN. § 104.055(b) (Vernon 1998).

TSE's failure to meet its burden of proof in *any one* of these key areas would make it difficult for the Examiners to compute a just and reasonable rate. In this case, TSE's failure to meet its burden of proof in *all* of these areas makes it impossible to set just and reasonable rates. Based on the lack of credible data in the record, the Examiners recommend that the Commission deny TSE's requested rate increase and dismiss TSE's Statement of Intent.

5. Discussion of Key Issues

1. Issue No. 1: Can TSE claim that the amounts shown on its books and records are *prima facie* evidence of the amount of investment or expense reflected, and can TSE claim the presumption of justness and reasonableness of those investment and expense items, under Commission Rule 7.58?[10]

Examiners' Recommendation: TSE has not kept its books and records in accordance with Commission rules, so it cannot claim that the amounts shown on its books and records are *prima facie* evidence of its investment or expense amounts, and it cannot claim that they are presumed to have been reasonably and necessarily incurred.

TSE's Position

TSE presented the *Gas Utilities 1998 General Annual Report of Texas Southeastern Gas Company* (1998 Annual Report) as *prima facie* evidence of the reasonableness of its expense and investment items.[11] However, evidence of numerous errors were brought out during cross examination by the Cities and the State. TSE argues that its errors in bookkeeping do not warrant a conclusion that its books and records are fundamentally flawed.[12] TSE argues that, although there were some errors in its Annual Report, the numbers are basically correct, so the total amount of expenses is correct, even if the numbers were not put into appropriate National Association of Regulatory Utility Commissioners (NARUC) accounts. Instead, Mr. Kirk Sprunger, Chief Financial Officer of TSE, testified that he used Generally Accepted Accounting Practices (GAAP) for his bookkeeping. In its Closing Statement, TSE claims that the presumption exists until a party presents "evidence" to rebut the presumption.[13] Interestingly, though, TSE does *not* argue that the Cities presented no evidence to rebut the presumption, or that the presumption exists even though TSE did not put the numbers into appropriate NARUC Accounts.

Cities' Position[14]

The Cities claim that TSE has not kept its books and records in accordance with Commission rules, so proper analysis is impossible. The Commission has adopted the NARUC System of Accounts in its rules and requires utilities to follow that system of accounts.[15] In addition, the Cities claim that TSE presented no evidence to support the reasonableness of its numbers, once challenged:

[10] 16 TEX. ADMIN. CODE § 7.58 (West 1999).

[11] TSE Ex. 5.

[12] *Texas Southeastern Gas Company's Reply to Closing Statements,* p. 2.

[13] *Texas Southeastern Gas Company's Reply to Closing Statements,* p. 1.

[14] The State filed only a brief Closing Statement, concurred with the City on all of its arguments, and made no additional arguments that could be listed separately. Therefore, the Examiners have not presented the State's position separately anywhere in this PFD.

[15] 16 TEX. ADMIN. CODE § 7.43 (West 1999).

"Without proper accounting, the process to determine the necessity and reasonableness of the expenses cannot begin."[16] The Cities further assert that "TSE seeks to minimalize and trivialize its failure to keep proper accounting records so that its operations can be properly analyzed by the ratepayers served by it and by the Commission. TSE admits that its accounting practices are not proper, but seeks to categorize them as 'technical' deviations from that which is required by the Commission rules."[17] Thus, the Cities argue that there can be no assurance that any of TSE's accounts are accurate, and until the accounts are made accurate, it is impossible for the Commission to grant TSE its requested rate increase.[18]

Examiners' Analysis

TSE has not kept its books and records in accordance with Commission rules, so it cannot claim that the amounts shown on its books and records are *prima facie* evidence of its investment or expense amounts, and such amounts are not presumed to have been reasonably and necessarily incurred. Commission Rule 7.58 is clear that the presumption only applies if TSE "keeps its books and records in accordance with commission rules."[19] The Examiners agree with the Cities that (1) the NARUC guidelines are required by Commission Rule 7.43, and (2) TSE has failed to maintain TSE's accounting records according to the NARUC System of Accounts, as required by Commission rules. Therefore, TSE cannot claim that its books and records constitute *prima facie* evidence of its investment or expense amounts, and such amounts are not presumed to have been reasonably and necessarily incurred.

While TSE's use of GAAP might be appropriate for certain types of businesses, GAAP does not address or fulfill the NARUC accounting procedures required by Commission rules for gas utilities. TSE's failure to use the required accounting practices has made it impossible for the Examiners to properly analyze TSE's investment and expense items for ratesetting purposes. Although TSE has some accounts that are labeled as NARUC accounts, on cross examination of Mr. Sprunger, it was shown that the accounts were not defined properly, and therefore the numbers in those accounts were not correct.[20] The assigned amounts simply did not meet the NARUC definitions for those accounts.[21] Although TSE's 1998 Annual Report specifically acknowledges the NARUC account requirement in the Commission rules, the following exchange between John Hays, Attorney for the Cities, and Kirk Sprunger, CFO of Yuma, illustrates TSE's failure to use those accounts for bookkeeping purposes. Mr. Sprunger testifies that he must use a cross-reference table:

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[16] *Closing Statement of the Cities of Brenham, et al.*, p. 5.
[17] *Id.*, p. 6.
[18] *Cities of Brenham, et al. Reply to the Texas Southeastern Gas Company's Closing Statement*, p. 4.
[19] 16 TEX. ADMIN. CODE § 7.58(a) (West 1999).
[20] Tr. Vol. 4, pp. 61-64.
[21] Tr. Vol. 4, pp. 65-77 and 80-81.

> Q. Am I correct that its financial data can be provided using the NARUC format. So are you telling us they don't actually use the NARUC system but they keep some kind of cross reference for TSE?
> **A. We actually have in our chart of accounts specific accounts that are NARUC so that they can accumulate the appropriate costs for both NARUC reporting and financial reporting. They are delineated specifically for pipeline utility purposes. And so we do, yes, have a cross reference to generate full-blown NARUC reports but we also carry NARUC in the chart of accounts.**
> Q. But this chart of accounts you use, that is not a NARUC chart that you use for basic recordkeeping, is it? To get it to NARUC, you have to go through this cross reference?
> **A. Generally speaking that is correct. However, there are accounts that are specific NARUC.**[22]

Gas utilities are required to keep their system of accounts according to NARUC unless they meet one of the two exceptions, in which case the gas utility is allowed to keep cross-reference accounts to NARUC in lieu of a full system of accounts. The exceptions are (1) it is only a gas gathering utility, or (2) it has FERC reporting requirements. Mr Sprunger admitted that TSE does not have any FERC reporting requirements and does not file a gas gathering annual report. Therefore, TSE is not entitled to keep only cross-referenced or partial NARUC accounts, which Mr. Sprunger admits is the way TSE kept its books during the test year.[23]

The Examiners conclude that TSE has not kept its records in the manner required by Commission rules, and TSE cannot, therefore, claim that its books and records constitute *prima facie* evidence of its investment or expense amounts, and such amounts are not presumed to have been reasonably and necessarily incurred.

2. Issue No. 2: Did TSE meet its burden of proof on its claimed investment, revenue and expense items?

Examiners' Recommendation: TSE failed to meet its burden of proof on its claimed investment, revenue, and expense items.

TSE's Position

TSE argues that although there were some errors in its Annual Report, the numbers are basically correct, so the total amount of expenses is correct, even if the numbers were not put into appropriate NARUC accounts. In response to the Cities' and State's cross examination of TSE's witnesses that showed numerous errors, TSE admits that certain costs either do not exist, were mis-classified, or were omitted from the TSE 1998 Annual Report, but argues that these errors do not warrant ignoring or reducing the costs that were reported:

[22] Tr. Vol. 4, pp. 61-62.
[23] Tr. Vol. 4, pp. 62-64.

> Mr. Sprunger testified that mis-classification of costs is 'very common,' does not make the costs reported any less real, does not change the bottom line total of all costs and does not result in a CPA's finding that the books were not kept in accordance with generally accepted accounting practices. In short, the mis-classification of costs for reporting purposes has no affect [sic] on the total costs that support TSE's rate request.[24]

Cities' Position

The Cities claim that TSE should have filed its application with all of the testimony and exhibits it believed necessary to support its requested relief, as required by Commission Rule 7.8(b).[25] The Cities and State presented evidence on cross examination which shows that TSE failed to use appropriate accounting and allocation methods, as confirmed in Examiners' Letter No. 13 (issued February 4, 2000):

> Based on the record presented at the hearing, the Examiners would find it difficult to recommend an accurate cost of service rate to the Commissioners because:
> (1) TSE has not consistently applied the NARUC, Texas Utilities Code and RRC Gas Utility guidelines in its business and accounting practices associated with this utility;
> (2) All of TSE's business support functions are served by its affiliates in the Yuma Companies, and there is no acceptable support for the cost allocation methodology as used for utility ratemaking purposes. In fact, Mr. Bank's and Mr. Sprunger's testimony clearly indicates that no written records were kept in support of the cost allocation methodology during the 1998 test year.

The Cities state that "it is clear that TSE has failed to meet its burden of proof because it has not followed the regulations of the Commission and, as required by the State Legislature in the Texas Utilities Code, has not properly accounted for its business, and has not kept adequate records to provide 'acceptable support for the cost allocation methodology' for its affiliate transactions."[26] The Cities also cite Examiners' Letter No. 15 (issued February 11, 2000), which contains the Examiners' Requests for Information, to argue that the breadth of the data requested by the Examiners' RFIs establishes that the case presented by TSE at the hearing was "starkly insufficient."[27]

Examiners' Analysis

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[24] *Texas Southeastern Gas Company's Reply to Closing Statements*, p. 2. (Footnotes omitted).
[25] 16 TEX. ADMIN. CODE § 7.8(b) (West 1999).
[26] *Closing Statement of the Cities of Brenham, et al.*, p. 4.
[27] *Id.*

TSE has the ultimate burden of proving that its proposed rate change is just and reasonable.[28] Because TSE's books and records are not *prima facie* evidence of its investment, revenue, or expense amounts, and such amounts are not presumed to have been reasonably and necessarily incurred, TSE has the burden of proof to show that all of its claimed investment, revenue, and expense items are accurate and reasonable.

Furthermore, the Cities and State introduced evidence to demonstrate that certain investment and expense items were unsupported, so even if the presumption existed, the burden shifts to TSE to introduce probative evidence that the challenged items are accurate and have been reasonably and necessarily incurred: "The presumption dissolves if 'any evidence is introduced that an investment or expense item has been unreasonably incurred'; if such evidence is introduced, the burden of production shifts again to the utility to introduce probative evidence of reasonableness."[29] The Examiners believe that, even if TSE had the presumption, the burden would have been shifted to TSE to meet its burden because of the evidence presented by the Cities and State. Therefore, even if TSE had the presumption, it failed to meet its burden to prove the reasonableness, necessity, or even the accuracy of the investment, revenue, and expense items presented at hearing.

TSE's failure to use proper NARUC account definitions, and its failure to place its investment, revenue, and expense items in proper NARUC accounts made it impossible for the Examiners to properly analyze the reasonableness of these items. In addition, TSE failed to introduce evidence to prove the accuracy of its numbers. Nonetheless, even if the investment, revenue, and expense items were accurate, the Examiners could not determine whether they were reasonable and necessary, because the record does not demonstrate which NARUC account they should have been associated with. At a minimum, TSE failed to properly use NARUC accounts for the following account numbers and titles, as demonstrated by the Cities and the State on cross examination:

NARUC Account No.	NARUC Account Title
750-769	Production and Gathering
800-804	Purchase Gas Expenses
332	Field Lines
850-867	Transmission Expense
271	Contributions in Aid of Construction
221-224	Long Term Debts
231	Notes Payable
233-234	Payables to Associated Companies
480-484	Gathering and Transmission Gas Sales in Texas
495	Other Gas Revenues
145	Notes Receivable From Associated Companies
901-905; 909-911	Operating Expenses
923, 925, 928	Legal Expenses
105	Property Held For Future Use
107	Construction Work in Progress

[28] TEX. UTIL. CODE ANN. § 104.008 (Vernon 1998). *See also City of Amarillo v. Railroad Comm'n of Texas*, 894 S.W.2d 491, 498 (Tex. App.--Austin 1995); *Coalition of Cities for Affordable Utility Rates v. Public Utility Comm'n of Texas*, 809 S.W.2d 332 (Tex. 1990).

[29] *City of Amarillo*, 894 S.W.2d at 498.

216	Unappropriated Retained Earnings
223	Advances From Associated CompaniesThis list merely provides a sampling, and is not an exhaustive list of the accounts that were discussed on cross examination as having some problem. In each instance, either the account was improperly defined, or numbers were misplaced, missing, or simply wrong.

In addition, TSE failed to prove the basis of many of its investment, revenue, and expense items, so the Examiners could not reclassify the numbers without further evidence. Major areas of investment, revenue and expense items that were challenged by the Cities include: Invested Capital and Return, Contributions in Aid of Construction (CIAC), Property Held for Future Use (PHFU), Gathering Facilities, and Capital Structure and Cost of Capital. These are each discussed in detail below. Each misclassified, omitted, or incorrect number results in faulty ratemaking calculations through the entire process. TSE admits that it left out some costs. Even TSE's Closing Argument demonstrates its failure to present a complete record:

> The costs in these areas either: (1) did not exist (gas gathering costs were minimal or non-existent, 3 Tr. 125), or (2) were reported elsewhere in the Annual Report (e.g. meter reading expenses, 4 Tr. 76, and legal costs for Commission proceedings, 4 Tr. 70-73), or (3) were omitted from the Annual Report and thus are not used to support the rates requested in this docket. The fact that certain costs either do not exist, were mis-classified or omitted from the report does not warrant ignoring or reducing the costs that were reported.[30]

By offering an incomplete picture of its revenue requirement, TSE makes it impossible to determine an accurate rate.

TSE relied heavily on the presumption of reasonableness, and failed to present evidence of the basis for most of its numbers. Without the presumption, TSE's 1998 General Annual Report is useless for ratemaking purposes without further support for its numbers. Even the 1998 Annual Report itself notes the requirement for gas utilities to use the NARUC uniform System of Accounts.[31] Paul Doll, as Vice President, signed the affidavit for TSE's 1998 General Annual Report, which was presented as *prima facie* evidence of the reasonableness of its expense and investment items. However, under cross examination by the Cities and State, Mr. Doll was not able to provide the basis for the many discredited numbers in this filing: "the accounting department prepares the reports. . . . I look over the report, but how they are classified from the accounting system that TSE uses over to the NARUC, I wouldn't be the one to testify on that. That would come under Mr. Sprunger's accounting department."[32]

Even the testimony of Ronald Nelson demonstrates his reliance on the presumption in Commission Rule 7.58, and how he failed to inquire into the basis of the numbers he used: "Based on my inquiries of TSE officers and accounting personnel, the annual financial review by TSE's outside auditors and the Railroad Commission auditors do not suggest that the annual report data is

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[30] *Texas Southeastern Gas Company's Reply to Closing Statements,* p. 2.

[31] TSE Ex. 5, p. 3 (General Instructions).

[32] Tr. Vol. 3, p. 133; *See also* Tr. Vol. 3, pp. 8-228 and Tr. Vol. 5, pp. 138-156.

inaccurate or misleading."[33] However, Mr. Nelson could not vouch for the basis of the numbers himself. Mr. Nelson relied on outside auditor reports that were not prepared for cost of service ratemaking purposes. Furthermore, TSE did not provide complete copies of these reports to the other parties as requested in discovery until the first day of the hearing.[34]

Therefore, the Examiners believe that it is impossible from the record to determine what numbers are correct, what numbers are missing, and what numbers are in the wrong category. The result is an incomplete record, on which the Examiners could not recommend accurate rates.

Although the Cities recommend denial of the rate increase, they filed a summary of their recommended values for unsupported amounts. The Cities' recommended adjustments are unnecessary because the numbers presented by TSE have not been shown to be reliable. The Cities' values were not used by the Examiners because they were as unsupported in the record as were TSE's schedules.[35] There are other areas in which the Cities did not specifically recommend reductions in TSE's requested values; however, the Cities make it clear that their lack of a specific recommendation does not serve as an endorsement of TSE's numbers.[36] Both the Cities and the State demonstrated on cross examination that TSE's witnesses could not support the numbers and schedules presented. However, neither the Cities nor the State offered witnesses, so there are no reliable numbers to replace those that were discredited. Therefore, the Examiners were unable to make any meaningful reductions or adjustments to TSE's numbers, and were left with inadequate and unreliable information with which to set a rate.

The five topics below are areas of major contention between the parties. Though it is not an exhaustive list, each topic provides an example of how TSE could not support its investment, revenue, or expense item once challenged by the Cities and the State.

1. Invested Capital & Return

TSE's Position

TSE proposed an original cost rate base of $1,519,699, based on TSE's original invested capital, less accumulated depreciation, additions for materials and supplies and working capital and a reduction for accumulated deferred income taxes.[37] TSE claims that the Cities agreed with all the adjustments and contested only the invested capital figure.[38]

Cities' Position

The Cities argue that TSE has put on no evidence of an original cost rate base or rate of return to be applied to an original cost rate base.[39]

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[33] TSE Ex. 2, p. 4.
[34] Tr. Vol. 2, pp. 20-32.
[35] *Closing Statement of the Cities of Brenham, et al.*, Exhibit A, various schedules.
[36] *Closing Statement of the Cities of Brenham, et al.*, pp. 5-6.
[37] *Texas Southeastern Gas Company's Closing Statement*, p. 24.
[38] *Closing Statement of the Cities of Brenham, et al.*, Ex. A, Schedule 3, lines 6, 8, and 9.
[39] *Cities of Brenham et al. Reply to the Texas Southeastern Gas Company's Closing Statement*, pp. 6-7.

Examiners' Analysis

The Examiners agree with the Cities' position that no evidence is in the record that supports TSE's claimed original cost. Schedule 3b of Mr. Nelson's pre-filed testimony shows the adjusted value of property calculation, but the only reference or explanation of the original cost section of the schedule is TSE's 1998 General Annual Report, which does not explain the basis for the numbers. On page 9 of his testimony, Mr. Nelson states, "The current cost amount is based on [sic] study performed by the Company's outside engineering consultants."[40] That is the only information provided about TSE's current cost value other than the value shown on Schedule 3b.[41] There is no further discussion of the original cost in Mr. Nelson's pre-filed testimony, and TSE did not offer the engineering consultants' report into evidence. Therefore, the Examiners recommend no value because neither the 1998 Annual Report nor Mr. Nelson's testimony contains any basis for the original cost and adjusted value of property claimed therein.

2. Contributions In Aid of Construction (CIAC)

TSE's Position

TSE points out that the Cities propose that invested capital be reduced by the difference between the CIAC figure in the Annual Report ($105,092) and the corrected figure supplied during discovery ($801,324). However, TSE argues that Mr. Sprunger explained that this adjustment can be made without also increasing invested capital by the same sum. The invested capital adjustment would be proper because TSE netted the CIAC against invested capital when it reported the lower sum of CIAC. Thus, TSE claims that when both adjustments are made, the net effect on total invested capital, and hence ratemaking, is zero. Therefore, according to TSE, the Cities' proposed adjustment should be rejected because it is one-sided and ignores the testimony of the witness with the most knowledge of how these matters were accounted for at TSE.[42]

Cities' Position

The Cities point out that TSE's witness Mr. Nelson reduced the original cost rate by $105,092 to account for CIAC. However, the discovery response filed by TSE indicated that CIAC should have been reported as $801,324. Accordingly, the Cities argue that there should be an additional reduction in original cost rate base of about $700,000.[43]

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[40] TSE Ex. 2, p. 9.
[41] TSE Ex. 2, Nelson Schedule 3b.
[42] *Texas Southeastern Gas Company's Reply to Closing Statements,* pp. 17-18. (Cites omitted)
[43] *Closing Statement of the Cities of Brenham, et al.* p. 8. (Cites omitted)

The Cities point out that TSE explains that it "nets" CIAC. That procedure is contrary to the Utility Plant Instructions of the Uniform System of Accounts, which provide:

> Utility plant contributed to the utility or constructed by it from contributions to it of cash or its equivalent shall be charged to the utility plant accounts at cost of construction, estimated if not known. There shall be credited to the accounts for accumulated depreciation, depletion and amortization the estimated amount of depreciation, depletion and amortization applicable to the property at the time of its contribution to the utility. The difference between the amounts included in the utility plant accounts and the accumulated depreciation, depletion and amortization shall be credited to account 271, Contributions in Aid of Construction.[44]

Account 271 states:

> A. This account shall include donations or contributions in cash, services, or property from states, municipalities or other government agencies, individuals, and others for construction purposes.
> B. The credits to this account **shall not be transferred to any other account without the approval of the Commission**.
> C. The records supporting the **entries to this account shall be so kept that the utility can furnish information** as to the purpose of each donation, the conditions, if any, upon which it was made, the amount of donations from (a) states, (b) municipalities, (c) customers, and (d) others, in the amount applicable to each utility department.[45]

The Cities point to TSE's failure to use the NARUC Uniform System of Accounts, or account for its operations under the instructions contained within those accounts, to argue that there can be no assurance that any of TSE's accounts are accurate. Therefore, TSE's numbers for CIAC are inaccurate and unreliable and should not be used.

Examiners' Analysis

The Examiners agree with the Cities position that TSE failed to properly apply the NARUC Uniform System of Accounts or follow the definitions of the contents of these particular accounts. Therefore, the Examiners' recommend no value for CIAC.

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[44] *Cities of Brenham et al. Reply to the Texas Southeastern Gas Company's Closing Statement*, pp. 2-3, citing Cities' Ex. 20 (NARUC Uniform System of Accounts, Utility Plant Instructions 2.D.).

[45] *Id.* (emphasis added)

3. Property Held For Future Use (PHFU)

TSE's Position

TSE points out that the Cities proposed that invested capital be reduced by $233,923, recorded in TSE's "Properties Held For Future Use" (PHFU) account, which represents the cost of a 6.25-mile-long, 6-inch pipeline that TSE purchased in 1997 in order to provide a second feed into Brenham.[46] TSE claims that PHFU has been recognized as a legitimate part of a utility's rate base from the inception of modern utility regulation in Texas.[47] In fact, the PUC has consistently permitted inclusion of PHFU in rate base if the utility could show that the property in question would likely be used within ten years of the end of the test year.[48]

TSE argues that this second feed into Brenham will be required within the next five years. TSE purchased the existing line for $233,923 because it was a "reasonable price," and because the cost of a new line could be more than $780,000. TSE also points out that Brenham presented no controverting testimony and claims that Brenham agrees that it needs another feed.[49]

Cities' Position

TSE included an additional pipeline to Brenham in its rate base plant that was being held for future use. Generally speaking, a utility is only allowed to include within its rate base those assets that are "used and useful in rendering service to the public."[50] In order for a plant held for future use to be included in the rate base, a utility generally has to establish that the particular facility was contained in a plan to be used and useful in providing service to the public within a certain period.[51] Therefore, the Cities claim that TSE failed to establish any of the necessary prerequisites, such as demonstrating the prudence of the investment and the definite plan to place its plant held for future use in the rate base as "used and useful" facilities. Accordingly, the plant held for future use should be excluded from rate base.[52]

Examiners' Analysis

The Examiners agree with the Cities' position that the subject pipeline to Brenham is not considered used and useful during the test year and should be excluded from rate base. TSE is correct that the case it cites states that the PUC allows ten years for PHFU to be put into service for electric service. However, TSE did not demonstrate that ten years is reasonable for this gas utility's PHFU. Also, the same case cited by TSE requires the utility to demonstrate "specific plans insuring that the particular investment will be fully used and useful."[53] TSE did not present any evidence to prove that a the extra pipeline was contained in a plan to be used and useful in providing service to

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[46] *Texas Southeastern Gas Company's Reply to Closing Statements*, p. 18. (Cites omitted).

[47] *Id.*, citing *Southwestern Bell Telephone Co. v. PUC*, 571 S.W.2d 503, 516 (Tex. 1978) (recognizing that land held for future use could be considered used and useful in providing service).

[48] *Id.*, citing *Cities For Fair Utility Rates v. PUC*, 924 S.W.2d 933, 937 (Tex. 1996).

[49] *Texas Southeastern Gas Company's Reply to Closing Statements*, p. 19. (Cites omitted).

[50] *Closing Statement of the Cities of Brenham, et al.*, citing *Cities For Fair Utility Rates v. Public Utility Comm'n of Texas*, 924 S.W.2d 933, 935 (Tex. 1996).

[51] *Id.*, citing 924 S.W.2d at 937.

[52] *Closing Statement of the Cities of Brenham, et al.*, pp. 8-9.

[53] *Cities For Fair Utility Rates v. PUC*, 924 S.W.2d at 937.

the public within a set amount of time. Finally, TSE's claim that it purchased the pipeline for a "reasonable price" does not make it used and useful. There is no proof in the record that the pipeline will be used or whether it is necessary, such as information about whether curtailment is an issue in gas deliveries to the Brenham city gate. Therefore, the Examiners recommend that this item be excluded from rate base.

4. Gathering Facilities

TSE's Position

In its closing statement, TSE points out that the Cities complain that gathering facilities had not been excluded from invested capital on the theory that they were not needed for transportation service. However, TSE argues that the field lines are fully depreciated, and thus add nothing to cost of service. The rights-of-way that are not yet fully depreciated should not be abandoned because there is still some drilling and these lines are used occasionally to move gas for the TSE system, and this gas could be purchased either by transportation customers or by TSE for system supply.[54]

Also, TSE claims that the Cities argument that these costs are "gas costs" should also be rejected because the only non-depreciated costs are those associated with field measuring stations, which are part and parcel of the cost of moving gas on the system, and must exist at every point where gas enters the system. Therefore, the costs are not costs of buying the gas itself.[55]

Cities' Position

The Cities claim that TSE did not separate its gathering costs from its transmission costs, making an analysis of the proper adjustment impossible. Also, TSE did not demonstrate that the property is used and useful to the customers to which the rate increase applies.[56] The Cities point out that TSE's gathering facilities were left in the rate base,[57] and argue that, if the gathering facilities were utilized to provide the gas supply for the city gate customers, they should not be included in the transmission expenses. Instead, the gathering lines, if the expenses is included at all, should be included in the gas cost calculation because they have nothing to do with the transport of gas to the city gate.[58]

Examiners' Analysis

The Examiners agree with the Cities' position that gathering and transmission expenses should be considered separately. Since all of the gathering and transmission costs cannot be identified separately in the record, no further analysis was presented or can be performed. Therefore, the Examiners find the gathering facilities information unreliable and unsupported in the record.

5. Capital Structure & Cost of Capital

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[54] *Texas Southeastern Gas Company's Reply to Closing Statements, pp. 20-21.* (Cites omitted).
[55] *Texas Southeastern Gas Company's Reply to Closing Statements,* pp. 20-21.
[56] TEX. UTIL. CODE ANN. §§ 104.053(e), 104.051 (Vernon 1998).
[57] *Closing Statement of the Cities of Brenham, et al.,* p. 16, citing Tr. Vol. 2, p. 196.
[58] *Closing Statement of the Cities of Brenham, et al.*, pp. 16-17.

TSE's Position

TSE argues that its requested return on invested capital of 13.75% is reasonable. Mr. Nelson testified that 13.75% was the return recommended by the Cities' consultant "for another small, intrastate pipeline (Webb/Duval Gatherers, GUD 8749)."[59] TSE argues that it is like Webb/Duval, in that they are both small intrastate gas pipelines and are subject to competition. However, TSE claims that TSE is much riskier than Webb/Duval, which makes 13.75% a conservative estimate of the return on invested capital for TSE. TSE claims that its greater risks were "related to the Cities' abrogation of their contracts, the ensuing litigation with the Cities, and TSE's potential refund exposure that exceeded its ability to pay."[60] TSE argues that "investors are interested in the risks of a business, not whether it sells the same kind of widget or has the same number of employees. These factors are simply ways of trying to judge whether the risks are similar."[61]

In addition, TSE applied the equity return of 7.89%[62] to the adjusted value rate base, not an original cost rate base. Therefore, TSE claims that the Cities' suggestion that it be applied to an original cost rate base is unfounded. TSE argues that the Cities' cost of equity number is useless for ratemaking purposes.[63] TSE claims that its recommended number is based on the evidence regarding TSE's total equity investment and the evidence regarding a realistic equity rate of return in light of TSE's risks.[64]

Cities' Position

[59] *Texas Southeastern Gas Company's Reply to Closing Statements*, p. 21, citing TSE Ex. 2, p. 9, ln. 17.

[60] *Texas Southeastern Gas Company's Reply to Closing Statements*, p. 21. (Citations omitted).

[61] *Texas Southeastern Gas Company's Reply to Closing Statements*, p. 22.

[62] Cited by the Cities as the return sought by TSE. *See also Closing Statement of the Cities of Brenham, et al.*, Schedule 5.

[63] *Railroad Commission v. Lone Star Gas Co.*, 618 S.W. 2d 121, 125 (Tex. Civ. App.--Austin 1981, no writ) (ratemaking methodology must be supported by record evidence). *Texas Southeastern Gas Company's Reply to Closing Statements*, p. 23.

[64] *Texas Southeastern Gas Company's Reply to Closing Statements*, p. 23; *See also Texas Southeastern Gas Company's Closing Statement*, pp. 23-27.

The Cities point out that a utility is entitled to only a "reasonable opportunity to earn a reasonable return" on its invested capital and not more than a "fair return on the adjusted value of the invested capital."[65] The Cities also argue that TSE presented no adequate evidence to prove the requested return on equity:

> TSE's witness Nelson recommended a 13.75% return on equity. That number was derived from an estimated return for a gathering system. There is no evidence that the other gathering system is comparable to TSE or that the return for the gathering system or for TSE is appropriate. The witness did not even review the annual report of the gathering company. Unless there is some evidence comparing TSE with the other gathering system, there is no basis for the comparison. Even TSE's witness admitted that the company was not comparable after being informed that the transportation rate set by the Commission for the other company was 12 cents per MMBtu. Again, TSE has failed to do even the most rudimentary analysis to support its proposed return on equity.[66]

In like manner, the Cities point out that TSE's proposed adjusted value rate base rate of return has no basis in reality:

> The adjusted value rate base rate of return was set by TSE's witness at 7.89%, which was a number used in an example in the Municipal Assistance Package prepared by the Commission. The return calculated by the TSE witness provides for a monetary return of approximately 60% of the common equity shown on Schedule 3c." Under any analysis, that amount is not a "reasonable return" and certainly is more than a "fair return." There is no evidence in the record of the hearing for any return to the equity of TSE. TSE used a proposed rate of return only for the purposes of creating a hypothetical revenue requirement.[67]

Examiners' Analysis

The Examiners agree with the Cities position that the 13.75% return on equity is not supported by any reliable evidence in the hearing record. The Cities are correct that there is no evidence that the other gathering system is comparable to TSE or that the return on equity for TSE (or for the other gathering system) is appropriate.

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[65] TEX. UTIL CODE ANN. §§ 104.051, 104.052 (Vernon Supp 2000).
[66] *Closing Statement of the Cities of Brenham, et al.,* pp. 14-15.
[67] *Id.,* p. 15.

In addition, TSE did not calculate a return on adjusted value rate base, but instead pulled the 7.89% figure directly out of the example in the Railroad Commission's Municipal Assistance Package. In his direct testimony, Mr. Nelson said he believed that the Commission has historically used 8% as a fair return on an adjusted value rate base.[68] When asked at the hearing by the Examiners about the basis for the 8% historical fair return, Mr. Nelson could provide no study or other support for the recommended value.[69] Therefore, there is no supported number in evidence for the adjusted value rate base rate of return.

As the above examples illustrate, TSE failed to meet its burden of proof on its claimed investment, revenue, and expense items. TSE's failure to follow NARUC guidelines, and its failure to provide reliable evidence to prove the accuracy of its numbers, lead the Examiners to the conclusion that TSE failed to provide enough reliable information with which to set rates.

3. Issue No. 3: Did TSE demonstrate that it used proper allocation methods between TSE and its affiliates?

Examiners' Recommendation: TSE has not proved a reasonable basis for the costs allocated between TSE and its affiliates. Therefore, TSE failed to present reliable evidence to demonstrate that it met the affiliate transaction standard found in Texas Utilities Code Section 104.055(b).[70]

TSE's Position

TSE argues that, under Texas Utilities Code Section 104.055(b), TSE must show that the supplier of affiliate services did not charge the utility more for these services than it charged to other affiliates and third parties. TSE claims that it was not charged more than other entities because the same methodology was used to allocate these kinds of costs to all affiliates. TSE claims that because TSE was allocated only 11% of Yuma's total costs for executive, legal and accounting services, and only 12.98% of the total G&A costs in the Houston office, TSE is not charged more than the other affiliates and third parties.[71]

Also, TSE argues that the "affiliate transaction statute" does not apply to TSE's charges to other entities. Instead, it applies only to a "gas utility's payment to an affiliate for the cost of a service, property, right or other item . . ."[72] Therefore, the amounts TSE charged others for services are not payments subject to the statute.

Cities' Position

The Cities argue that gas utilities are required by statute to carefully prove the necessity and reasonableness of costs incurred through services or other supplies made available to the gas utility by affiliated companies.[73] Further, the Cities claim that TSE has not provided acceptable support for

[68] TSE Ex. 2, p. 9.
[69] Tr. Vol. 2, pp. 213-215. (Examiners' questions for Ronald Nelson).
[70] TEX. UTIL. CODE ANN. § 104.055(b) (Vernon 1998).
[71] *Texas Southeastern Gas Company's Closing Statement*, pp. 17-18.
[72] *Texas Southeastern Gas Company's Reply to Closing Statements*, p. 13.
[73] *Closing Statement of the Cities of Brenham, et al.*, p. 5.

the cost allocation of the services supplied to TSE by its affiliated companies: "TSE's failure to properly account for its activities is egregious given the fact that the allocations of services from affiliated companies has been a major point of contention in the past (GUD Nos. 8749-8754) and was expected to be so in this case."[74]

The Cities point is that TSE has not quantified or justified the total costs incurred by Yuma and charged or allocated to TSE, so the Examiners have no evidence from which to determine the reasonableness of these costs: "TSE's assumption is that if TSE's method of allocation is reasonable (it is not), then the costs allocated or charged are reasonable - irrespective of their magnitude, applicability to TSE, ongoing level, or non-recurring nature."[75] The Cities point out, for example, that TSE seeks multiple recovery of prior rate case expenses and recovery of non-recurring legal expenses based on current levels of activity, which is unlikely to continue at present levels. These costs of a nonrecurring nature are not properly included in the cost of service numbers.[76] The Cities point is that TSE has not proved the reasonableness of the numbers allocated between TSE and its affiliates.

Examiners' Analysis

The Examiners agree with the Cities that TSE has not demonstrated compliance with the "affiliate transactions statute," in that TSE has not proved a reasonable basis for the costs allocated between TSE and its affiliates. The statute requires:

> In establishing a gas utility's rates, the regulatory authority may not allow a gas utility's payment to an affiliate for the cost of a service, property, right, or other item or for an interest expense to be included as capital cost or as expense related to gas utility service except to the extent that the regulatory authority finds the payment is reasonable and necessary for each item or class of items as determined by the regulatory authority. That finding must include:
> (1) a specific finding of the reasonableness and necessity of each item or class of items allowed; and
> (2) a finding that the price of the gas utility is not higher than the prices charged by the supplying affiliate to its other affiliates or divisions or to a nonaffiliated person for the same item or class of items.[77]

In his testimony, TSE witness Kirk Sprunger, CFO of TSE and other subsidiaries of Yuma, describes the allocation methodology applied to all of Yuma's expenses, including TSE's expenses.[78] Mr. Sprunger makes no distinction between affiliate and non-affiliate transactions. The record does not contain any explanation of the reasonableness and necessity of these transactions based on affiliate connections.

On cross examination, the Cities and State discredited Kirk Sprunger's schedules and his allocation methodology as improper for cost of service ratemaking purposes. In particular, the basis

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[74] *Closing Statement of the Cities of Brenham, et al.*, p. 5.
[75] *Cities of Brenham et al. Reply to the Texas Southeastern Gas Company's Closing Statement*, pp. 4-5.
[76] *Id.*, p. 5.
[77] TEX. UTIL. CODE ANN. § 104.055(b) (Vernon 1998).
[78] TSE Ex. 4, pp. 6-9.

for allocating employee time is not supported by any third party or in-house time studies, time sheets, or records of any kind. Instead, Mr. Sprunger testified that the top management estimated the time that employees spent for each affiliate.[79] Also, there is no way to compute the total number of employees or FTEs that work for TSE because the employees work for Yuma, with no clear delineation of what work is being done for the utility, TSE. Therefore, the Examiners agree with the Cities that TSE failed to use an appropriate allocation method for affiliates.

This allocation problem is indicative of the overall problem that TSE does not appropriately track TSE's investment, revenue, and cost items under NARUC standards in accordance with the Texas Utilities Code. Instead of keeping separate accounting records for TSE, Yuma runs TSE as a branch of Yuma, rather than as a regulated utility. Most of the cost allocations were from both Yuma and its subsidiaries, none of which are utilities serving city gates. It is apparent from Mr. Sprunger's responses to cross examination that there is little separation between TSE, the only regulated utility owned by Yuma, and its other non-regulated affiliates.[80]

Based on the record, the Examiners can recommend no value for any assigned expenses from TSE's affiliates because there is no way to verify the amount of allocated expenses that should be assigned for ratemaking purposes. This failure to justify affiliate expenses is one key reason that the Examiners could not determine an accurate cost of service rate with the current record.

4. Issue No. 4: Did TSE present reliable evidence to support its utility revenue and expense adjustments and rate design methods?

Examiners' Recommendation: TSE did not fully address or support typical gas utility revenue and expense adjustments and rate design methods.

In a typical case, a test year is chosen that provides representative operating data to be used in calculating a just and reasonable rate. Adjustments are then applied as needed to minimize risk and more accurately reflect utility operating conditions for prospective rate setting.[81] TSE's failure to perform these types of adjustments is another reason the Examiners were unable to recommend cost of service rates in this docket.

[79] Tr. Vol. 4, pp. 33-40, 49.

[80] Tr. Vol. 4, pp. 33-40, 102-129; TSE Ex. 4, Schedule KFS -1.

[81] *See, i.e.,* TEX. UTIL. CODE §§ 101.003, 104.055 (Vernon 1998); TEX. ADMIN. CODE §§ 7.50, 7.51, 7.52, and 7.56 (West 1999). *See also* States' Ex. 2, pp. 31-35, 40.

TSE filed a Statement of Intent to increase rates in July 1999 because it claims it would lose money under the rates set as a result of GUD Nos. 8749-8754.[82] In this case, however, the Examiners were unable to determine if TSE is gaining or losing money under the existing or proposed rates. It appears that TSE's net income (profit) is essentially based on the difference between the cost of gas and its selling price to the city gates.[83] TSE claims that it is a high-risk venture; however, TSE has failed to incorporate utility ratemaking tools available to minimize its risks. For example, none of the typical revenue and expense adjustments noted in the Commission's Natural Gas Rate Review Handbook were applied. The three examples below are indicative of TSE's failure to use normal ratemaking methods.

1. Weather Normalization and Purchased Gas Adjustment

TSE's Position

TSE argues that weather normalization is not necessary because it is not likely to change the rate case result significantly, and the technique is not an accurate predictor of "normal" weather in today's environment. TSE claims that weather normalization done today would use weather data from 1961-1990. However, TSE argues that for the past decade, weather normalization has not worked because not a single season in the past decade has been as cold as normalization would predict. Thus, more recent weather patterns are a better short term predictor today than thirty years of historical data:

> Intervenors' suggestion -- that the already high 1998 volumes be increased by "normalization" -- should be rejected because the weather normalization technique is out of date. It uses data from the 1960's through the 1980's and does not reflect the warmest decade on record, the 1990's, or the fact that temperatures have gotten warmer as the 1990's have progressed.[84]

Therefore, TSE claims that its uncorrected test year volumes are more accurate for ratemaking purposes than if weather normalization was applied, so it used actual 1998 volumes in its rate calculations.[85]

Additionally, TSE did not argue either for or against the use of a PGA clause in its tariff.

Cities' Position

The Cities argue that weather normalization is critical to determining the correct test year volumes for allocation and ratemaking purposes:

> One of the basic adjustments that need to be made in a rate case presentation is to account for an abnormally warm or cold test year since much of a gas utility's consumption, especially residential and commercial, depends upon the weather. The

[82] *Texas Southeastern Gas Company's Closing Statement,* pp. 1-2; TSE Ex. 3, p. 4, lns. 4-11.
[83] *Texas Southeastern Gas Company's Closing Statement,* pp. 28-33; TSE Ex. 3, pp. 11-12.
[84] *Texas Southeastern Gas Company's Closing Statement,* p. 32.
[85] *Texas Southeastern Gas Company's Reply to Closing Statements,* p. 28.

Gas Services Division Natural Gas Rate Review Handbook, dated November 9, 1999, provides:

> Gas sales adjustments are commonly made to account for the net effect of below average and above average heating degree days during a test year. The adjustment is computed by comparing the actual number of heating degree days to normal heating degree days experienced the year of the test year. Test year gas sales volumes and revenues are adjusted to reflect a normal heating degree day year.

State Cross-Examination Ex. 2; II TR. at 160-161. Despite the publication indicating that weather normalization should be done, TSE made no such adjustment in the test year numbers.[86]

The Cities do not support a PGA clause in lieu of TSE's recommended index rate because there was no testimony or proof presented on the subject: "TSE provided no proof regarding its ability to control prices for gas purchased, the probability of continued frequent price changes, and the availability of alternate gas supply sources as required by the Commission rule 16 TAC Section 7.55."[87]

Examiners' Analysis

The Examiners believe that TSE should have used both weather normalization and a PGA clause. In this case, applying weather normalization and a purchased gas adjustment clause would allow TSE to recoup costs for unusual weather events and pass through the actual cost of each gas purchase. In this manner, TSE could minimize the impact of weather on its revenues and expenses.

The Cities are correct that TSE should have performed a weather normalization adjustment. TSE should have adjusted its sales volumes and revenues during the test year to reflect the "average heating degree day" for that year.[88] A weather normalization adjustment would create a "normal heating degree day year" that helps form the revenue requirement for the test year. The purpose of weather normalization is to "account for the net effect of below average and above average heating degree days during a test year."[89] This would help eliminate many of TSE's concerns about abnormally warm weather, such as TSE claims is occurring this decade.

Furthermore, the Examiners believe that TSE's use of a PGA clause would enable it to reduce its financial risk, unlike the index rate proposed by TSE. TSE admits that its current tariff exposes it to the risk of weather fluctuations:

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[86] *Closing Statement of the Cities of Brenham, et al.*, p. 11, citing State's Ex. 2, p. 33.
[87] *Closing Statement of the Cities of Brenham, et al.*, p. 15.
[88] State's Ex. 2, p. 33.
[89] *Id.*

> In addition to creating large swings in demand, the Cities' weather-sensitive load also increases TSE's risks and this increased risk should be reflected in the Cities' rate. The risk arises from the fact that when demand goes up after the 1st of the month, TSE must buy more gas at usually higher prices to meet the Cities' demands, but the price TSE can charge for that gas is fixed by the index price on the first of the month. Similarly, when weather is warmer than expected after the 1st of the month, TSE may have to sell gas at prices below what it paid for the gas at the 1st of the month.[90]

A PGA allows "the utility to recover its fuel costs on a timely basis without the need for a formal rate proceeding."[91] If TSE would use a purchased gas adjustment clause and adjust for weather normalization, it could have a more stable cash flow and reduce its financial risk. TSE failed to present evidence to support either of these ratemaking methods.

2. Cost Allocation and Rate Design

TSE's Position

TSE claims that it used the Commission's Municipal Assistance Package, which says that fixed costs are typically allocated on the basis of peak demand.[92] Mr. Nelson testified that this is the preferred approach for allocating costs when customers have considerable differences between peak demand and normal demand.[93] According to TSE, the pure volumetric method favored by the Cities is not used when pipelines have both significant space heating loads and significant volumes of non-weather sensitive load.[94]

In response to the Cities' argument that TSE did not use the simultaneous peak, TSE argues that Mr. Nelson made the common sense assumption, that the customers experienced their peak days on the same day in the peak month because the Cities' peak demands are driven by weather, and the service area is small, so a cold front moving through will drive demand higher in each city on the same day.[95]

In response to the Cities' argument that peak load allocation is not proper when there is excess capacity in the pipeline system, TSE argues that the Cities cite no authority for the proposition that the only purpose of peak day allocation is to ration pipeline capacity. Instead, Mr. Nelson testified that the main purpose of this allocation method is to properly assign fixed costs, not to ration capacity.[96]

Cities' Position

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[90] *Texas Southeastern Gas Company's Closing Statement,* p. 29; *See also* TSE Ex. 3, pp. 11-12.
[91] State's Ex. 2, p. 40.
[92] *Texas Southeastern Gas Company's Reply to Closing Statements,* p. 25, citing State's Ex. 2, pp. 31-32.
[93] *Texas Southeastern Gas Company's Reply to Closing Statements,* p. 25, citing TSE Ex. 2, p. 6, lns. 8-10.
[94] *Texas Southeastern Gas Company's Reply to Closing Statements,* p. 25.
[95] *Id.,* p. 26.
[96] *Id.*

The Cities argue that TSE provided no basis for its use of peak demand allocation. TSE's witness Mr. Nelson testified that the methodology of peak demand allocation is "the preferred approach" only because it is listed as the first example of allocation methodologies in the ratemaking "assistance package."[97] The Cities claim that Mr. Nelson assumed that all customer peaks would occur on the same day in the peak month, rather than using the simultaneous peak methodology which utilizes the peak demand of the system and assigns costs to each customer class at that point.[98]

Furthermore, the Cities argue that peak load allocation is not proper when there is excess capacity in the pipeline system. The Cites point out that TSE has not had a curtailment in many years. However, in 1998, the system had sufficient excess capacity to serve all of its customers without curtailment, whereas Mr. Nelson admitted that peak load pricing is designed for capacity rationing.[99] The Cities claim that, on TSE's system, peak load allocation is not needed for rationing of pipeline capacity, but in GUD No. 2012, TSE had its rates based on volumetric allocation.[100] Therefore, there is no basis to modify the Commission's latest determination in GUD Nos. 8749-8754 and change from the volumetric allocation of costs.[101]

Examiners' Analysis

The Examiners agree with the Cities' position that the peak-day demand allocation is not correctly applied by TSE. Also, TSE does not adequately justify its basis for choosing the peak-day demand cost allocation in its rate design. Mr. Nelson picked a day during the peak month and assumed that all customer peaks would occur on the same day on that month.[102] The peak demand allocation method is appropriately applied by choosing the peak demand of the system as a basis, and assigning costs to each customer class for that peak. TSE's methodology would be called "modified peak demand" under the Rate Review Handbook, rather than "peak demand," which indicates to the Examiners that TSE's witness did not fully understand the method he applied.[103]

More importantly, Mr. Nelson admitted that he used the peak demand methodology because it was the first one on the list in the Municipal Assistance Package.[104] The Cities are correct that TSE should not have changed from the volumetric method used in previous dockets. The "modified peak demand" method used by TSE is designed for a system that is at maximum capacity, and TSE did not discuss its system capacity. Therefore, TSE presented inadequate evidence to support its allocation methodology.

3. Post-Test Year Adjustments

TSE's Position

TSE argues that, consistent with Public Utilities Commission (PUC) Rule 23.21(b), post-test year adjustments should be made only when all "attendant impacts are known and measurable.[105]

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[97] *Closing Statement of the Cities of Brenham, et al.*, p. 17, citing Tr. Vol. 2, p. 102.
[98] *Closing Statement of the Cities of Brenham, et al.*, p. 17.
[99] *Id.*, citing Tr. Vol. 2, p. 106.
[100] *Id.*, citing Tr. Vol. 2, p. 211.
[101] *Closing Statement of the Cities of Brenham, et al.*, p. 17.
[102] Tr. Vol. 2, pp. 103-104.
[103] State's Ex. 2, p. 31.
[104] Tr. Vol. 2, p. 102.
[105] *Texas Southeastern Gas Company's Reply to Closing Statements*, p. 3.

TSE notes that Texas courts have determined that changes occurring after the end of a test year for which attendant impacts are not known and measurable are to be considered in the next rate proceeding: "The inquiry into reasonable operating expense is a 'snapshot' inquiry based on the test year. It is not intended to account for future cost changes. Adjustment for these changes will be made in future cases."[106]

TSE argues that all costs are changing, and will likely increase through time and offset any savings due to other changes that might lower costs. As an example, TSE states that approximately 20% of TSE's allocable departmental General and Administrative (G&A) costs were allocated to Texas Southeastern Gas Gathering (TSEGG), which was sold over the period 1997-1999.[107] Thus, the more than $115,000 of TSE costs that were once allocated to TSEGG must now be borne by TSE itself, and this one item offsets any savings due to Mr. Doll's departure from employment with Yuma and TSE in mid-November 1999.

Also, TSE does not believe that any adjustments should be made to remove Paul Doll's salary and related costs form test year expenses. Instead, TSE claims that individuals picked up some of Mr. Doll's tasks, and a greater portion of their salaries should be allocated to TSE. However, TSE claims that the proper additional amount to allocate to TSE cannot be known with certainty until TSE has some experience operating without Mr. Doll. Therefore, since not all of the "attendant impacts" of Mr. Doll's departure can be measured and quantified at this time, TSE claims that no adjustment of test year figures is warranted.[108]

Additionally, TSE argues that the City of Tomball is to leave the system in March 2000. TSE claims that the departure of this customer will not reduce TSE's non-gas costs, but it will certainly reduce peak day and annual volumes by a known amount - the test year volumes. Thus, TSE argues that the "attendant impacts" of this change are known and measurable and it should be recognized in setting rates.[109]

Finally, TSE argues that the result of the appeal of GUD Nos. 8749-8754 is unknown, so it should not be taken into account. The District Court could possibly remand the matter to the Commission for a new rate case. Therefore, TSE claims that if it brings a new rate case, the Commission can evaluate it on its own terms.

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[106] *Id. See Cities of Abilene v. PUC*, 854 S.W.2d 932, 943 (Tex. App.--Austin 1993), aff'd in part and rev'd in part on other grounds, 909 S.W.2d 493 (Tex. 1995).

[107] *Texas Southeastern Gas Company's Reply to Closing Statements*, p. 4.

[108] *Texas Southeastern Gas Company's Reply to Closing Statements*, p. 3.

[109] *Id.*

Cities' Position

The Cities claim that TSE failed to fully adjust for what it claims are known and measurable changes. The Cities point out that "test year amounts need to be adjusted and normalized to reflect the period in which they are to be charged."[110] The Cities argue that it is the failure of TSE to provide the necessary data to make such adjustments that causes this case to be impossible to determine.[111]

In order to demonstrate the minimum adjustments required because of TSE's inadequate case, the Cities presented necessary adjustments, but claim that the lack of data prevents additional adjustments that need to be made, such as a growth adjustment, to account for the expected increased gas usage over test year volumes.[112]

Finally, the Cities claim that TSE has not demonstrated what costs should be reduced because of Tomball's leaving - only the volumes. Since Tomball has not yet left, its associated costs and volumes should not be adjusted out of the analysis.

Examiners' Analysis

The Examiners conclude that TSE presented inadequate evidence to determine the effects of some post-test year changes that could have been accounted for if TSE had presented enough evidence. Known and measurable changes beyond the test year are generally part of the cost of service filing, so that the prospective rate accurately reflects utility operating conditions.

Both TSE and the Cities correctly describe the standard for determining which post-test year changes should be taken into account in the current rate. TSE focuses on the fact that the changes must be fully known and measurable, while the Cities focus on the fact that the test year amounts need to be adjusted to reflect the period in which they are to be charged. In a typical case, a test year is chosen that provides representative operating data to be used in calculating a just and reasonable rate. Known and measurable changes beyond the test year are also included so that the prospective rate accurately reflects utility operating conditions.[113] The Texas Supreme Court points out that "the historic test year amounts must be adjusted to more accurately reflect costs which will be incurred in the future. These adjustments include normalizing and prospective adjustments such as removing non-recurring expenses, modifying test year data to reflect the number of customers served at the end of the period and modifying expenses and rate base for known and measurable changes."[114]

In this case, TSE did not offer adequate evidence to determine whether some post- test year changes are known and measurable. There must be evidence in the record of the "attendant impacts" of these changes in order to use them as a basis for setting rates. Below are changes which either have already occurred or are in the process of occurring, for which TSE failed to present adequate evidence.

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[110] *Cities of Brenham et al. Reply to the Texas Southeastern Gas Company's Closing Statement*, p. 2, citing *Public Utility Commission of Texas v. GTE-Southwest Inc.*, 901 S.W.2d 401, 411 (Tex. 1995).

[111] *Closing Statement of the Cities of Brenham, et al.*, p. 20.

[112] *Closing Statement of the Cities of Brenham, et al.*, p. 21 and Attachment A.

[113] *See* State's Ex. 2, pp. 31-35, 40. (Natural Gas Rate Review Handbook, November 1999).

[114] *Public Utility Commission of Texas v. GTE-Southwest Inc.*, 901 S.W.2d at 411.

Since Paul Doll left TSE in November, 1999 and was a witness in this case, the Examiners believe that TSE should have introduced additional testimony to explain how his job responsibilities were distributed within TSE. This change cannot be accounted for because there is no evidence in the record to support it.

The Examiners recommend no adjustment for the City of Tomball's impending exit from TSE's system because TSE provided no specific customer count or expense information associated with Tomball. Both Mr. Nelson and Mr. Banks testified that they didn't think that Tomball's leaving would have any significant impact on TSE's expenses, but they presented no customer counts or expense information to support their opinions.[115] Although TSE presented evidence of the revenues associated with Tomball's volumes, the revenues should not be removed without also removing the associated costs.[116] Therefore, because all the "attendant impacts" cannot be determined, the Examiners conclude that no adjustment can be made for this impending change.

In like manner, the Examiners cannot determine the necessary growth normalization adjustments related to Tomball's exit, because TSE did not present the information necessary to make the adjustments. The purpose of growth normalization is to match the test year revenue with the year end investment.[117] The adjustment changes the book revenues to reflect the total number of customers receiving service at the end of the test year, including known and measurable changes after the test year. If TSE had presented adequate evidence of Tomball's customer counts, expenses, and utility plant dedicated to Tomball, this adjustment could be made.

Finally, the Examiners agree with TSE that the result of the appeal of GUD Nos. 8749-8754 is unknown, so it should not be taken into account.

5. Issue No. 5: Should the Commission order an audit of TSE's books?

Examiners' Recommendation: The Examiners recommend that a complete audit of books, records, and tariffs be performed by Commission staff.

The Examiners recommend that a complete audit of books, records, and tariffs be performed by Commission staff. The Commission should order audit staff to present its findings and recommendations to the Commission when complete. The purpose of the audit would be to determine to what extent TSE is complying with Commission rules and what action, if any, should be taken to bring this utility into compliance.

[115] Tr. Vol. 2, pp. 146-147; Tr. Vol. 2, p. 147; Tr. Vol. 5, p. 9; Tr. Vol. 5, p. 9.
[116] State's Cross Ex. 2, p. 33.
[117] State's Cross Ex. 2, pp. 32-33.

The record indicates that TSE has little or no experience with cost of service bookkeeping and ratemaking. TSE acquired this system in 1991. According to Sam Banks, current sole stockholder of TSE and its parent, Yuma, the city gate rates were negotiated as part of the purchase agreement.[118] Since 1991, TSE's city gate rates have not been changed based on a typical cost of service filing with the Commission. In fact, TSE appears never to have intended to have its rates set by the Commission. Part of the 1991 purchase agreement stipulates that TSE would not come before the Commission for a rate filing until TSE's contracts with the Cities expired: "TSE agrees that during the primary term of the gas contracts TSE will not make any rate filing with the Railroad Commission of Texas as part of this or any other governmental agency having authority over the pricing to increase the price of natural gas purchased by the Cities from TSE pursuant to the gas contracts without the written express consent of the Cities."[119] Sam Banks further testified: "And we did not go with a rate case because we had negotiated a contract with all the Cities which they had all ratified.[120]

The Texas Utilities Code, however, provides for regulation of gas utilities by the Railroad Commission:

> Gas Utilities are by definition monopolies in the areas they serve. As a result, the normal forces of competition that regulate prices in a free enterprise society do not operate. Public agencies regulate utility rates, operations, and services as a substitute for competition.[121]

Throughout the proceeding, it became apparent that TSE does not act as a monopoly which has its rates set by the Commission based on cost of service. According to Mr. Banks, a key reason TSE filed this request for a rate increase is TSE believes that the Cities abrogated their contracts with TSE, and the Commission-ordered rates set in the GUD Nos. 8749-8754 are so low that TSE would be losing money due to competition in the gas markets with those rates.[122]

The record indicates that none of TSE's employees or witnesses has substantive gas utility cost of service ratemaking experience, which might explain why TSE's Statement of Intent does not conform with gas utility ratemaking principles. According to Kirk Sprunger, Chief Financial Officer of TSE and other Yuma subsidiaries, no TSE or Yuma employee has received any training on gas utility regulations, and no employee with gas utility regulatory experience has been hired.[123]

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[118] Tr. Vol. 5, p. 13.
[119] Tr. Vol. 5, pp. 60-61
[120] Tr. Vol. 5, p. 24.
[121] TEX. UTIL. CODE § 101.002(b) (Vernon 1998).
[122] Tr. Vol. 5, pp. 44-48.
[123] Tr. Vol. 5, pp. 172-173.

Furthermore, Mr. Ronald Nelson, TSE's "cost of service" rate consultant and witness, had not previously prepared and testified to a complete cost of service gas utility rate filing before this or any other Commission.[124] Mr. Nelson responded to inquiries about his ratemaking experience by citing references to segments of work prepared for gas and electric utilities within and outside of Texas.[125] In addition, neither Paul Doll nor Sam Banks has gas utility regulatory experience.[126]

Given the deficiencies shown by the record in this case, the Examiners believe that a complete audit, and possibly a general rate inquiry by staff, would be appropriate.

6. Rate Case Expenses

Examiners' Recommendation: The Examiners recommend that the Commission deny TSE recovery of its rate case expenses if the Commission finds that it is unable to set just and reasonable cost of service rates.

The Commission has the authority to determine whether TSE's rate case expenses are reasonable.[127] If the Commission approves the Examiners' recommendation to deny TSE's requested rate increase, the Commission should find that TSE's rate case expenses are not reasonable, and deny their recovery, because TSE failed to meet its burden of proof.

TSE's total requested rate case expenses are $218,283.39. The Cities do not contest that this amount was spent by TSE, but the Cities argue two reasons that the Commission should deny TSE's rate case expenses: TSE's requested rate case expenses are unreasonable because TSE failed to meet its burden of proof, and because its rate case duplicates TSE's appeal of GUD Nos. 8749-8754, and is therefore unnecessary.

1. Should TSE be denied rate case expenses because it failed to meet its burden of proof in this rate case?

TSE's Position

TSE argues that cases regarding the recovery of rate case expenses evidence the fact that "rate cases are complex undertakings in which one party seldom wins or loses entirely. If cost-based rates are set as a result of the docket, rate case expenses are routinely included in cost of service to the extent such costs are found to have been necessary and reasonable."[128] Therefore, TSE argues that rate case expenses are, in this sense, no different than any of the utility's other costs.

Cities' Position

The Cities argue that the Commission should deny TSE's requested rate case expenses if it finds that TSE failed to meet its burden of proof. Under Commission Rule 7.57, a utility claiming reimbursement for rate case expenses has the burden to prove the reasonableness of such rate

[124] Tr. Vol. 2, pp. 138-140.
[125] *Id.*
[126] Tr. Vol. 5, p. 21.
[127] 16 TEX. ADMIN. CODE § 7.57 (West 1999).
[128] *Texas Southeastern Gas Company's Closing Statement on Rate Case Expenses*, p. 8.

expense by presenting evidence, including detailing all expenses, allocations, and providing evidence of the reasonableness of all professional services. The Cities place great weight on the rule that requires the Commission to consider all relevant factors, including "whether the request for rate change was warranted" and "the amount of the increase sought as well as the amount of any increase granted." Therefore, the Cities claim that because TSE has failed to meet its burden of proof, its rate case was not warranted, and the Commission's denial of a rate increase should be accompanied by a denial of its requested rate case expenses.

The Cities point to court decisions that have upheld the Commission when it disallowed certain rate case expenses, finding such action to be within the Commission's discretion.[129] In addition, the Cities claim that the Railroad Commission has held that the failure of a party to prove its case is a basis for denying rate case expenses. The Commission found that the appeal to the Commission was not warranted, and that the ratepayers should not bear the cost of the expense of the utility to put on the unnecessary case.[130] In like manner, the Cities argue that they should not be required to pay for TSE's unnecessary rate case, especially in light of TSE's failure to meet its burden of proof.

Examiners' Analysis

The Commission should determine that TSE's rate case expenses are unreasonable if it denies TSE's requested rate increase and finds that TSE failed to meet its burden of proof due to its failure to present reliable information with which to set rates. While the Commission should encourage utilities to file rate packages with the Commission when they require rate increases, the Commission also should encourage utilities to follow Commission rules in its practices and in its rate filings. The cases cited by the Cities support a sound policy that rate case expenses should be borne by the stockholders, rather than the ratepayers, when a utility fails to meet its burden of proof and the Commission finds that there is no merit in the rate request. In this case, TSE has failed to follow Commission rules and failed to present a rate case with which the Commission could set just and reasonable rates. Because TSE failed to meet its burden of proof, the Commission may deny its requested rate case expenses, and the Examiners recommend that they do so.

2. Should TSE be denied rate case expenses because its Statement of Intent duplicates its appeal of Commission Orders in GUD Nos. 8749-8754?

TSE's Position

TSE claims that its financial condition necessitated bringing this rate case, regardless of the Commission's decision in this docket. TSE claims that the rates set in GUD Nos. 8749-8754 are too low for TSE to operate:

> The transportation rate in particular was set so low that even a few months of providing service at that rate would put TSE out of business. Thus, prompt relief

[129] *Cities of Brenham, et al. Brief on Rate Case Expenses,* p. 7, citing *City of Amarillo v. Railroad Comm'n of Texas*, 894 S.W.2d 491 (Tex. App.—Austin 1995, writ den.).

[130] *Id.*, p. 8, citing Tex. R.R. Comm'n, *Consolidated Appeals of Rio Grande Valley Gas Co. of the Actions of the Cities of Alamo et al.*, Gas Utilities Docket No. 3858 Consolidated (PFD issued July 1, 1983, Final Order issued August 1, 1983).

> was essential. Since the transportation rate was based on only a fraction of TSE's costs from 1996, TSE filed a new rate case so equitable cost-based rates could be determined. TSE viewed the prompt establishment of cost-based rates as essential to its survival during the pendency of the appeal of GUD 8749.[131]

Also, TSE argues that this rate case does not duplicate the appeal of GUD Nos. 8749-8754. Instead, TSE claims that its rate case is based on different costs and will be forward-looking in nature, not retrospective. Regardless of the outcome of the appeal, TSE claims that it will still need a transportation rate that can be effective immediately, because TSE desires to offer transportation service. TSE claims that it will also need a sales rate that could be made effective when the contracts expire on September 1, 2000, and its rate case was intended to provide both of those rates. Moreover, TSE argues:

> Nothing in law or equity prevents a utility from appealing one rate decision and filing a rate case to establish new rates. This is particularly true when the first case sets rates so low that bankruptcy is threatened. A utility is not required to complete a multi-year appeal process, and go broke in the process, when more prompt relief can be obtained via a rate case. The effect of the new rate case is simply to create a defined time period in which to rates being appealed will be in effect, and thus, limit the effectiveness of any rates set on remand.[132]

Cities' Position

The Cities argue that this rate case was not necessary. The Cities have twice filed Motions to Dismiss based on their argument that this rate case is duplicative with TSE's appeal of GUD 8749-8754, because the outcomes of both proceedings overlap. The Cities argue that this case is analogous to the case of *Industrial Utilities Service Inc.*[133] In that case, the Court of Appeals held that it was justifiable for the Texas Natural Resource Conservation Commission (TNRCC) to deny rate case expenses to a utility that testified against its own application. In like manner, the Cities argue that TSE would not be pursuing this rate case if it wins the appeal.

The Cities point to the testimony of TSE's Vice President, Mr. Paul Doll, who acknowledges that this case arises solely from the results in GUD Nos. 8749-8754:

> Q. Why has TSE filed this rate case given that the Commission set rates for the Cities in an order issued June 22, 1999 in GUD 8749?

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[131] *Texas Southeastern Gas Company's Closing Statement on Rate Case Expenses*, p. 3.

[132] *Id.*, p. 2.

[133] *Industrial Utilities Service Inc. v. Texas Natural Resource Conservation Commission*, 947 S.W.2d 712 (Tex. App.--Austin 1997, writ den.).

> A. TSE is filing this rate case because the rates that were set by the Commission are too low and TSE would not be able to survive on those rates. The Commission set the sales and transportation rates without considering the Company's actual costs as they would relate to TSE earning a reasonable rate of return on its invested capital. The Commission set the sales rate based on the contract price of another customer (TDCJ) without even considering if this price was adequate for TSE to earn a reasonable return. The transportation rate adopted by the commission was based on the calculations of the Cities' expert witness. In those calculations, the witness eliminated a large amount of TSE's expenses that were included in its General Annual Report to the Railroad Commission. The witness had no basis for eliminating the expenses and did so based, in his words, "solely on my own judgment and experience." By accepting the witness' calculations, the Commission has not considered whether TSE would be able to earn a reasonable return based on its actual operating costs. In fact, based on the sales and transportation rates set by the Commission, TSE would not be able to cover its operating costs and would not be able to stay in business.[134]

The telling point in this quotation, according to the Cities, is that Mr. Doll admitted that the reason for filing the new case is that TSE did not agree with the result in GUD Nos. 8749-8754. Even Mr. Sam Banks, TSE's President, agreed with Mr. Doll.[135] The Cities' argument is that this case is merely another "appeal" of GUD Nos. 8749-8754, and is therefore unnecessary, so the rate case expenses from the prior proceeding should have covered the expenses for this proceeding. Therefore, the Cities argue that, as this case seeks the same outcome as the appeal, the Commission here should rightfully determine that any rate case expenses for this proceeding were unreasonable, unnecessary, or not in the public interest, and that the utility's customers should not be obligated to pay them.[136]

Examiners' Analysis

The Examiners do not agree with the Cities that the similar outcomes sought by TSE in the appeal of GUD Nos. 8749-8754 and in this rate case indicate that this rate case is unnecessary. Instead, the Examiners cannot determine from the record whether TSE needs an increase as requested, or whether the Cities are correct that the rates set in GUD Nos. 8749-8754 are adequate for TSE to continue doing business. TSE has not presented enough reliable evidence to tell whether TSE needs an immediate rate increase, or whether TSE will lose money and go bankrupt if it cannot get a rate increase. As described in this PFD, TSE's affiliate transactions and cost allocation problems make it impossible to tell the financial viability of TSE as a stand-alone company, so the Examiners cannot determine whether this rate case was necessary or not.

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[134] TSE Ex. 3, p. 3-4.
[135] Tr. Vol. 5, pp. 75-76.
[136] *Cities of Brenham, et al. Brief on Rate Case Expenses*, pp. 6-7.

The Cities are correct that TSE seeks almost the same results in this rate case as it does in its appeal - to change the rates set in GUD Nos. 8749-8754 back to approximately what they were under the contracts. The Cities correctly point out that TSE's witnesses admitted that this rate case was an alternate means of achieving the results TSE seeks in its appeal of GUD Nos. 8749-8754. However, the Examiners have twice denied the Cities' motions to dismiss that were based on this same argument. Instead, the Examiners allowed TSE an opportunity to prove its case in hearing, and TSE's failure to meet its burden of proof has made it impossible for the Examiners to determine whether TSE's requested rate increase is necessary for TSE's financial well being.

Therefore, the Examiners do not recommend denial of TSE's rate case expenses on the basis that it duplicates TSE's appeal of GUD Nos. 8749-8754. Instead, the Examiners conclude that the Commission should deny TSE's rate case expenses because of TSE's failure to meet is burden of proof in this case.

7. Examiners' Recommendation

The Examiners recommend that the Commission deny TSE's request for a rate increase and dismiss TSE's Statement of Intent. After reviewing the record, the Examiners can find no just and reasonable basis to set any rate. In addition, the Examiners recommend that the Commission deny TSE's requested rate case expenses because TSE has failed to meet its burden of proof.

Furthermore, the Examiners recommend that the Audit Section of the Gas Services Division perform a complete audit of the TSE's books, records, and tariffs to determine TSE's level of compliance with Commission rules, and to make recommendations for Commission action.

8. Proposed Order

Attached to this PFD is a Proposed Order which contains findings of fact and conclusions of law that are consistent with the Examiners' recommendations herein.

Issued this 28th day of April, 2000.

Respectfully submitted,

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GAS UTILITIES SECTION

STATEMENT OF INTENT TO CHANGE SALES AND TRANSPORTATION RATES OF TEXAS SOUTHEASTERN GAS COMPANY ESTABLISHED IN GUD NOS. 8749-8754	**§ § § § §**	**GAS UTILITIES DOCKET NO. 8958**

PROPOSED ORDER

Notice of Open Meeting to consider this Order was duly posted with the Secretary of State within the time period provided by law pursuant to TEX. GOV'T CODE ANN. Ch. 551 (Vernon 1994 & Supp. 2000).

This complaint was duly considered following notice and hearing by a hearings examiner who filed a Proposal for Decision containing findings of fact and conclusions of law in accordance with 16 TEX. ADMIN. CODE § 1.141 (West 1999). The Proposal for Decision was properly served on all parties, and all parties were given an opportunity to file exceptions and replies as part of the record as authorized under 16 TEX. ADMIN. CODE § 1.142 (West 1999). The Commission, after review and due consideration of the Proposal for Decision, adopts the following Findings of Fact and Conclusions of Law.

FINDINGS OF FACT

1. Texas Southeastern Gas Company (TSE) is a gas utility, under TEX. UTIL. CODE § 101.003(7) (Vernon Supp. 2000), that serves the Cities of Brenham, Hempstead, Navasota, Sealy, Tomball, and Waller, Texas (Cities) at their city gates.

2. In April of 1999, the Railroad Commission of Texas (Commission) set TSE's sales and transportation rates for the Cities in Gas Utilities Docket (GUD) Nos. 8749-8754, *Complaint of the Cities of Brenham, et al. Against Texas Southeastern Gas Company*. Those dockets were initiated by a complaint filed by the Cities against TSE.

3. On July 30, 1999, TSE filed with the Commission a Statement of Intent under TEX. UTIL. CODE ANN. § 104.102 (Vernon 1998) to change the city gate sales rates and transportation rates established by the Commission in GUD Nos. 8749-8754 for the Cities at their city gates.

4. In its Statement of Intent, TSE requested the following changes to its current rate schedule:

    1. A city gate sales rate equal to the *Inside FERC* Houston Ship Channel/Beaumont, Texas index (large packages only) for the first day of the month for which gas is being billed, adjusted for variances in gas actually taken, plus 65.4¢ per MMBtu.

    2. A transportation rate of 65.4¢ per MMBtu, subject to adjustment for imbalances between nominations and actual deliveries.

Procedural History

5. On August 24, 1999, the Commission issued a Suspension Order, pursuant to TEX. UTIL. CODE ANN. § 104.107 (Vernon 1998), which suspended the proposed rates for a period of one hundred fifty (150) days from the date the rates would otherwise go into effect.

6. In its Statement of Intent, TSE designated its proposed effective rates for the new rates as September 3, 1999; however, that date was subsequently changed and, on February 24, 2000, TSE designated January 17, 2000 as the proposed effective date. One hundred fifty (150) days from January 17, 2000 is June 15, 2000.

7. The Cities opposed TSE's request to increase its rates and filed a Motion to Dismiss the filing; the Cities were granted party status in this proceeding at the first prehearing conference conducted on August 30, 1999.

8. At the first prehearing notice, the Examiners approved the form of notice to be published by TSE and TSE represented that notice would be published for four consecutive weeks, beginning the week of August 30, 1999. The evidentiary hearing was scheduled to begin on November 17, 1999.

9. On October 22, 1999, the Examiners denied the Cities' Motion to Dismiss.

10. On November 17, 1999, the Examiners convened the evidentiary hearing. Before evidence was presented, TSE announced that notice had not been published beginning the week of August 30, 1999 as originally anticipated during the first prehearing conference. The Examiners, therefore, ruled that the hearing could not go forward until notice was completed.

11. On November 19, 1999, the Examiners issued Examiners' Letter No. 5, directing TSE to publish notice; the Examiners also rescheduled the evidentiary hearing for December 17, 1999, and established TSE's effective date as December 4, 1999, resulting in a rate bond-in date of March 3, 2000. Although TSE appealed to the Commission with respect to the bond-in date, the Commission denied the appeal by Order signed December 7, 1999.

12. TSE published notice of its Statement of Intent once each week for four successive weeks in newspapers having general circulation in each county containing territory affected by the proposed increase. The notice was published between November 10 and December 9, 1999 in the Brenham Banner-Press, the Waller County News Citizen, the Navasota Examiner-Review, The Sealy News, and the Tomball/Magnolia Potpourri.

13. On November 24, 1999, the Cities filed their Second Motion to dismiss; the Examiners denied the Motion on January 20, 2000.

14. On December 16, 1999, the State of Texas filed a Motion to Intervene and a Motion to Continue Hearing. On December 17, 1999, the Examiners postponed the hearing to January 21-26, 2000, and allowed the State intervener status on behalf of affected state agencies, hospitals, and colleges within the corporate limits of the cities served by TSE. On January 14, 2000, the Examiners denied party status to Prairie View A&M University,

Brenham State School, and the Texas Department of Criminal Justice, all represented by the State of Texas.

15. The Examiners granted intervener status to the Cities, and to the State of Texas, on behalf of affected state agencies, hospitals, and colleges within the corporate limits of the cities served by TSE.

16. On December 22, 1999, the Examiners issued notice of the hearing to commence on January 21, 2000.

17. The hearing commenced on January 21, 2000, and concluded on January 26, 2000. TSE pre-filed testimony and presented evidence at the hearing. Although the Cities and State did not file testimony or present any witnesses, they participated at the hearing by cross-examining the witnesses. An additional hearing regarding rate case expenses was held on March 24, 2000.

18. The Examiners held a Post-hearing Conference on February 7, 2000, wherein they continued the hearing for the submission of additional evidence. The Cities and the State appealed the Examiners' ruling, and on February 24, 2000, the Commission granted the appeals, reversing the Examiners' ruling, and directing the Examiners to proceed to a decision on the record developed at hearing.

19. On February 15, 2000, TSE filed additional information as requested by the Examiners. The information was not admitted as evidence, per the Commission's February 24, 2000 ruling.

20. Closing arguments and replies were filed by TSE, the Cities and the State on March 14, 2000 and March 21, 2000 respectively. On March 24, 2000 the Examiners held a hearing on rate case expenses. Briefs on rate case expenses were filed on April 4, 2000, and Reply Briefs were filed on April 7, 2000. The Examiners closed the record on April 7, 2000.

Hearing on the Merits

21. During the evidentiary hearing, TSE presented the *Gas Utilities 1998 General Annual Report of Texas Southeastern Gas Company* (1998 Annual Report) which it claimed to be prima facie evidence of the reasonableness of its expense and investment items, pursuant to Commission Rule 7.58, 16 TEX. ADMIN. CODE § 7.58 (West 1999). Commission Rule 7.58 states that "In any proceeding before this commission involving a gas utility that keeps its books and records in accordance with commission rules, the amounts shown on its books and records as well as summaries and excerpts therefrom shall be considered prima facie evidence of the amount of investment or expense reflected when introduced into evidence, and such amounts shall be presumed to have been reasonably and necessarily incurred."

22. TSE's books and records have not been maintained according to the National Association of Regulatory Utility Commissioners (NARUC) accounts, as required by Commission Rule 7.43, 16 TEX. ADMIN. CODE § 7.43 (West 1999).

23. TSE did not introduce evidence that would support findings on the reasonableness and necessity of its requested rates, or any other rates, without the 16 TEX. ADMIN. CODE § 7.58 (West 1999) presumption.

24. Neither the Cities nor the State presented expert testimony to introduce evidence with which rates could be set.

25. TSE did not introduce reliable evidence to support its claimed investment, revenue, and expense items.

    1. TSE presented its 1998 Annual Report and witnesses' schedules, but they are not considered *prima facie* evidence of the reasonableness of TSE's expense and investment items because they were not kept in accordance with Commission rules.

    2. TSE's 1998 Annual Report and its witnesses' schedules contained numerous errors.

    3. TSE's witnesses failed to introduce any reliable basis for TSE's claimed investment, revenue, and expense items, once challenged.

    4. TSE did not introduce evidence that would support a specific finding on the reasonableness and necessity of its invested capital and return.

    5. TSE failed to introduce adequate evidence to support a specific finding on its claimed contributions in aid of construction (CIAC).

    6. TSE failed to introduce adequate evidence to support a specific finding on its claim that property held for future use (PHFU) is used and useful in rendering service to the public.

    7. TSE failed to introduce adequate evidence to support a specific finding on its gathering facilities and transmission costs separately.

    8. TSE failed to introduce adequate evidence to support a specific finding on its claimed capital structure and cost of capital.

26. TSE failed to present reliable evidence to demonstrate that it met the affiliate transaction standard found in TEX. UTIL. CODE ANN. § 104.055(b) (Vernon 1998).

    1. TSE is a subsidiary of the Yuma Companies, Inc. (Yuma), the parent company for seven affiliate companies, including TSE.

    2. TSE did not provide reliable information to support the allocation of costs and expenses between itself, Yuma, and the other affiliates.

27. TSE did not present reliable evidence to support its utility revenue and expense adjustments and rate design methods.

    1. TSE failed to perform a typical weather normalization adjustment or employ a Purchased Gas Adjustment Clause, which reduce the risk of irregular weather patterns.

    2. TSE did not introduce evidence that would support a specific finding on the reasonableness and necessity of TSE's proposed cost allocation and rate design methods.

    3. TSE did not introduce evidence that would support a specific finding on the reasonableness and necessity of post test year adjustments for known and measurable changes.

        1. Paul Doll, Vice President, left employment with TSE in November 1999, but inadequate evidence was presented of the necessary adjustments in the record.

        2. The City of Tomball is leaving TSE's system, but inadequate evidence was introduced in the record to determine what all of the known and measurable changes should be.

28. Based on Findings of Fact Nos. 10 - 15, it is reasonable to conclude that TSE is not in compliance with numerous Commission rules; it is therefore reasonable to order Commission's audit staff to perform a complete audit of TSE's books, records and tariffs to determine whether Commission action is necessary to bring TSE into compliance with Commission rules.

29. Because TSE failed to meet its burden of proof, it is reasonable to conclude that its rate case expenses were not reasonably incurred and, therefore, should not be recovered from its ratepayers.

CONCLUSIONS OF LAW

30. TSE is a gas utility as defined in TEX. UTIL. CODE ANN. §§ 101.003(7) and 121.001 (Vernon Supp. 2000).

31. TSE complied with the notice requirements in TEX. UTIL. CODE ANN. § 104.103 (Vernon 1998).

32. The notice of hearing issued by the Examiners on December 22, 1999 satisfied the requirements of 16 TEX. ADMIN. CODE § 1.45 (West 1999) and TEX. GOV'T CODE ANN. § 2001.052 (Vernon Supp. 2000).

33. TSE is subject to cost of service standards in Titles 3 and 4 of the Texas Utilities Code.

34. The Commission is required to ensure that all rates charged by a utility are just and reasonable under TEX. UTIL. CODE ANN. § 104.003(a) (Vernon 1998).

35. TSE has the burden of proof in this case to show that its proposed rates are just and reasonable under TEX. UTIL. CODE ANN. § 104.008 (Vernon 1998).

36. TSE failed to meet its burden to prove that its proposed rates are just and reasonable under TEX. UTIL. CODE § 104.008 (Vernon 1998).

37. TSE cannot claim that the amounts shown on its books and records are *prima facie* evidence of the amount of investment or expense reflected, and cannot claim the presumption of justness and reasonableness of those investment and expense items under 16 TEX. ADMIN. CODE § 7.58 (West 1999), because TSE did not keep its books and records in accordance with the National Association of Regulatory Utility Commissioners (NARUC) system of accounts as required by 16 TEX. ADMIN. CODE § 7.43 (West 1999).

38. The record does not support findings on the reasonableness and necessity of investment and expense items without the 16 TEX. ADMIN. CODE § 7.58 (West 1999) presumption.

39. TSE failed to meet its burden of proof in this case to show that its proposed rates are just and reasonable under TEX. UTIL. CODE ANN. § 104.008 (Vernon 1998).

40. The record does not support findings on TSE's adjusted value of invested capital used and useful to the utility in providing service, which is used in determining overall revenues and a fair rate of return, under TEX. UTIL. CODE ANN. §§ 104.051, 104.052, and 104.053 (Vernon 1998).

41. The record does not support findings on TSE's "net income," which is used to establish just and reasonable rates, under TEX. UTIL. CODE ANN. § 104.055(a) (Vernon 1998).

42. TEX. UTIL. CODE ANN. § 104.055(b) (Vernon 1998) requires the Commission to make a specific finding on the reasonableness and necessity of affiliate transactions.

43. Because TSE did not provide reliable information to support the allocation of costs and expenses between itself, Yuma, and the other affiliates, TSE did not meet its burden to prove the reasonableness and necessity of its affiliate transactions under TEX. UTIL. CODE ANN. § 104.055(b) (Vernon 1998).

44. TSE's failure to meet its burden of proof to establish that its rate request was warranted is sufficient basis for denial of any recovery from ratepayers of it rate case expenses in this docket. 16 TEX. ADMIN. CODE § 7.57 (West 1999).

45. The Commission has the authority to employ or appoint persons as necessary to inspect and audit TSE's records, receipts, disbursements, vouchers, prices, payrolls, time cards, books, and property, under TEX. UTIL. CODE ANN. § 121.157 (Vernon 1998).

IT IS THEREFORE ORDERED by the Railroad Commission of Texas that TSE's request to increase its rates as set out in its Statement of Intent filed on July 30, 1999, is hereby **DENIED**.

IT IS FURTHER ORDERED that the rates previously ordered by the Commission in GUD Nos. 8749-8754 shall remain in effect.

IT IS FURTHER ORDERED that TSE shall not recover its rate case expenses from its ratepayers.

IT IS FURTHER ORDERED that TSE shall file tariffs with the Commission incorporating the rates ordered by the Commission in GUD Nos. 8749-8754 within 30 days of the date of this Order.

IT IS FURTHER ORDERED that TSE undergo a complete audit by the Commission's Gas Services Division's Audit Section, to begin within six months, to inspect TSE's property and records and determine whether TSE is in compliance with Commission rules. The audit staff shall present its findings and recommendations to the Commission when complete.

IT IS FURTHER ORDERED that all proposed findings of fact and conclusions of law not specifically adopted herein are **DENIED**.

Signed this _____ day of _____, 2000

RAILROAD COMMISSION OF TEXAS

Chairman

Commissioner

Commissioner

ATTEST:

Secretary